

MEMO# 2338

November 21, 1990

CALIFORNIA TREATMENT (FOR PASS-THROUGH PURPOSES) OF U.S. TERRITORY AND AGENCY OBLIGATIONS

- 1 - November 21, 1990 TO: TAX MEMBERS NO. 49-90 MONEY MARKET MEMBERS - ONE PER COMPLEX NO. 16-90 RE: CALIFORNIA TREATMENT (FOR PASS-THROUGH PURPOSES) OF U.S. TERRITORY AND AGENCY OBLIGATIONS

As we previously informed you, California enacted legislation this year to expand the "pass-through treatment" for regulated investment companies ("RICs") provided by section 17145 of the California Taxation and Revenue Code. Pursuant to the change, California exempted from state tax the portion of a RIC's dividends attributable to obligations the interest on which, if received directly by an individual, would be exempt from tax under the Constitution or laws of either the United States or California, so long as certain other conditions were satisfied. (See Institute Memorandum to Tax Members No. 20-90 and Money Market Members - One Per Complex No. 8-90, dated June 15, 1990.) Prior to this expansion of pass-through treatment, California exempted from state tax only those "obligations of the United States" that pay interest exempt from state tax pursuant to federal law. The California Franchise Tax Board interpreted the phrase "obligations of the United States" to preclude pass-through treatment for interest attributable to obligations of U.S. territories (such as Puerto Rico) and certain government agencies on the ground that they are not "obligations of the United States", even though the interest paid on them to individual investors is exempt from state tax pursuant to federal law. Consequently, the effect of this expansion of pass-through treatment was to permit interest on territorial obligations and certain government agency obligations to flow through a RIC exempt from California taxation. A recent "technical correction" to section 17145 may have the effect of denying pass-through treatment to the territorial and agency obligations covered by the earlier expansion. The technical correction added a limitation similar to that provided under federal law by Code section 852(b)(5)(A) for situations in which the amount designated as an exempt-interest dividend is greater than the excess of the amount of exempt interest over - 2 - certain disallowed deductions. Although section 17145 still - 3 - defines "exempt-interest dividend" to mean any part of a RIC dividend attributable to "obligations which when held by a individual, the interest therefrom is exempt from taxation by this state under the Constitution or laws of this state or the United States" (emphasis added), the technical correction limits the amount of the exempt-interest dividend to "obligations, interest on which, if held by an individual, is exempt from taxation by the state under the Constitution or laws of this state, and on obligations of the United States which pay interest excludable from income under the Constitution or laws of the United States" (emphasis added). We understand that the California Franchise Tax Board views this technical correction as unintentionally precluding

interest on territorial and agency obligations from flowing through a RIC exempt from California tax. We further understand that the Franchise Tax Board may recommend that this inadvertent change be remedied by a further technical correction. It is unclear whether any legislative change, if enacted, would be retroactive to the effective date of the first technical correction. We will keep you informed of developments. Keith D. Lawson
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